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Commercial Dispute Resolution Legal Update

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"True and fair view" equated with compliance accounting standards – *Macquarie Internationale Investments Ltd v Glencore UK Ltd* [2009] EWHC 2267 (Comm)

The recent Commercial Court decision in *Macquarie Internationale Investments Ltd v Glencore UK Ltd* held that a warranty in a sale and purchase agreement that a company's financial statements gave a "true and fair view" was a single, indivisible requirement; and, apart from exceptional circumstances, would be met if the accounts complied with the relevant accounting standards.

Macquarie claimed damages from Glencore for breach of a number of warranties in a sale and purchase agreement ("SPA") pursuant to which Macquarie acquired the shares in Corona Energy Holdings Ltd, a leading supplier of energy, primarily natural gas, to the commercial sector in the UK. Macquarie alleged that Corona's subsidiaries had incurred various charges to a company, Xoserve Ltd, which were not recognised in the relevant accounts or disclosed to Macquarie, in breach of the warranties in the SPA. The charges which were not included in the liabilities in the accounts included those for gas supplied through certain meters for which Xoserve had not charged Corona, because of a computer error.

The warranties given to Macquarie in the SPA about the audited statutory accounts for Corona and its subsidiaries included typical forms of warranty to the effect that the accounts had been prepared in accordance with relevant accounting standards and gave a "true and fair view" of the assets and liabilities of the group being purchased.

Macquarie therefore argued both that the value of the missed charges was a liability that should have been recognised in the accounts in order to comply with relevant accounting standards and that the accounts did not give a true and fair view.

The judge found on the facts that there was not sufficient evidence available to Corona's board (at any time before completion of the sale to Macquarie) of the existence of the missed charges, so that Corona was not able properly to recognise the charges as a liability in the accounts and the accounts had therefore been prepared in accordance with the relevant accounting standards. The first limb of Macquarie's argument therefore failed.

However, as to the second limb, Macquarie argued that the relevant accounting standards requirement and the true and fair view requirement constituted two separate warranties and that they should be given effect separately and independently of each other. The first was concerned with the "process" of compiling the accounts and the second with the "outcome of that process". Consequently, for the purposes of determining whether the accounts gave a "true and fair view", it was irrelevant whether Corona knew of, or had evidence of, the missed charges when the accounts were compiled and signed.

The judge rejected these submissions, finding that while there was a linguistic distinction, the two provisions were "*intimately connected*". Further, it would be "*an arid and unhelpful exercise*" to decide, as separate questions, whether financial statements are "true" and "fair". In this, he relied upon the unreported decision in *Senate Electrical Wholesalers Ltd v STC Submarine Systems Ltd*¹, where May J commented that "*Generally accepted accounting principles and practices tend to import 'true and fair view' and vice versa*".

The judge also made clear that he regarded the phrase "true and fair view" in the warranties to have the same meaning as its use in sections 226A(2) and 227A(2) of the Companies Act 1985. In this context, the judge referred to the joint opinion of Leonard Hoffmann QC and Mary Arden for the Accounting Standards Committee in September 1983 on the meaning of the phrase. From this, he drew out the essential point that the concept necessarily related to the expectations that accounting practices generated.

However, finally, the judge drew back from expressing the view that the fact that financial statements were prepared in accordance with Financial Reporting Standards ("FRSs") necessarily meant that they gave a true and fair view. Although he did not give an example, he noted that there might be exceptional circumstances where the requirement in sections 226A and 227A of the Companies Act 1985 for a true and fair view overrode the requirement to comply with accounting standards. However, there were no such exceptional circumstances in this case, where Corona had no sufficient evidence of a liability and could not therefore be expected to provide for it in its accounts.

In summary, the fact that a company complies with relevant FRSs of itself will tend to satisfy the requirement for accounts to give a true and fair view. There may be exceptional circumstances where this does not apply but it remains to be seen where the dividing line may lie.

¹ 20 December 1996, unreported.

Construction of ISDA Master Agreements and the law of mistake – Marine Trade SA v (1) Pioneer Freight Futures Co Ltd BVI and (2) Armada (Singapore) PTE Ltd [2009] EWHC 2656 (Comm)

This recent case considered the operation of the controversial section 2(a)(iii) of the International Swap Dealers Association (Multicurrency-Cross Border) Master Agreement (the "Master Agreement"), which provides for suspension of payments to a party subject to an "Event of Default", such as insolvency. It also considered the scope of a claim for mistake in circumstances where the party claiming to have been mistaken was actually in doubt as to its rights.

The claimant, Marine Trade ("Marine"), and the first defendant, Pioneer, entered into a number of Forward Freight Agreements ("FFAs") between May 2007 and September 2008. The 2007 Terms of the Forward Freight Agreement Brokers Association ("FFABA"), which governed each of the FFAs, incorporated the terms of the 1992 ISDA Master Agreement.

An FFA on the FFABA 2007 Terms is a cash-settled contract for differences referenced to the index rate or rates published by the Baltic Exchange as selected by the parties. For each of the FFAs a "Settlement Sum" was calculated each Contract Month from the difference between the "Contract Rate" agreed between the parties and the "Settlement Rate" for the particular month derived from the Baltic Exchange indices.

In the fourth quarter of 2008 a dramatic fall in the freight market led to a significant difference between the Contract Rates fixed under the FFAs in a more robust market and the Settlement Rates linked to the Baltic Exchange indices. This resulted in the "Seller" under each FFA being substantially "in the money".

For the January 2009 Contract Month the Settlement Sums were as follows:

- US\$ 7,085,981.85 under the FFAs for which Marine was the Seller; and
- US\$ 12,116,223.67 under the FFAs for which Pioneer was the Seller.

On a net basis there was therefore a balance of approximately US\$ 5 million in favour of Pioneer for January 2009, which was due to be settled by 6 February 2009. By the end of January, Marine considered that Pioneer was affected by an insolvency Event of Default within the meaning of the Master Agreement and so, because of section 2(a)(iii), was not entitled to net the sums payable to it against the sums payable to Marine under section

2(c) (Netting) of the Master Agreement. Consequently, Marine invoiced Pioneer for the Settlement Sum of US\$ 7,085,981.95.

Pioneer, taking the view that it was entitled to net the sums payable, invoiced Marine for the net balance of around US\$ 5 million. Marine failed to settle the net balance by the Settlement Date of 6 February 2009 and, accordingly, Pioneer served a notice of failure to pay under section 5(a)(i) of the Master Agreement, which would have constituted an Event of Default by Marine if not remedied.

Marine was concerned that Pioneer would serve a notice of early termination under section 6(a) of the Master Agreement if it failed to remedy. If this had occurred, each party would have become liable to pay all unpaid sums under the FFAs. In the market at that time, this would have resulted in a substantial sum being payable by Marine to Pioneer.

In order to prevent that outcome, Marine paid the net balance of around US\$ 5 million under protest. It then served its own notice on Pioneer under section 5(a)(i) of the Master Agreement in respect of Pioneer's failure to pay the Settlement Sum of US\$ 7,085,981.85.

The court was required to determine three key legal issues:

1. Netting: whether Pioneer could net sums owed to it against sums owed to Marine, if it was affected by an Event of Default.
2. Subsequent Event of Default: whether Pioneer would be relieved of having to pay the Settlement Sum of US\$ 7,085,981.95 if Marine later became affected by an Event of Default.
3. Payment under protest: whether Marine could recover in restitution the sum of just over US\$ 5 million it had paid to Pioneer under protest.

The section 2(a)(iii) controversy

The court held that, as Pioneer was subject to an Event of Default under the Master Agreement, it could not net sums owed to it against sums owed to Marine pursuant to section 2(c) of the Master Agreement. Section 2(c) permits netting in respect of "payable" amounts and "payable" must mean now due and owing. As Pioneer was affected by an Event of Default, Marine had no obligation to make payments to Pioneer at all because of section 2(a)(iii) of the Master Agreement. As a result, there were no sums payable that were capable of being netted pursuant to section 2(c). Significantly for derivatives markets, the English court has thereby enforced the suspensive effect of section 2(a)(iii) (though Pioneer seems not to have argued that section 2(a)(iii) was unenforceable *per se*, as might be argued in some circumstances, for instance by relying on the anti-deprivation principle under English insolvency law).

As such, the decision is one of a limited number of cases which have considered the operation of section 2(a)(iii). Although the validity of section 2(a)(iii) was not expressly considered, the judge appeared to assume that the clause would be enforceable. Different approaches to the operation of section 2(a)(iii) have been taken in other jurisdictions, most notably in the September 2009 decision of the US Bankruptcy Court hearing the Lehman bankruptcy proceedings, where the court held that section 2(a)(iii) could not be invoked to suspend payments because it infringed provisions of the US Bankruptcy Code. Conversely, an earlier Australian decision in a case relating to the collapse of Enron (*Enron Australia v TXU Electricity* [2003] NSWSC 1169) upheld the right to suspend payments and supported the enforceability of contractually flawed asset provisions, such as section 2(a)(iii). The law in this area is developing and there remains a risk of conflicting decisions in different jurisdictions.

Although Pioneer was the first party to become affected by an Event of Default by the end of January 2009, Marine itself subsequently became subject to an insolvency Event of Default in April or May. Pioneer argued that its obligation to pay Marine US\$ 7,085,981.95 was extinguished as a result of Marine's subsequent Event of Default or, alternatively, suspended until the Event of Default was cured.

The court held that, provided that the requirements of section 2(a)(iii) were satisfied at the relevant Settlement Date, i.e. that there was no subsisting Event of Default by Marine at that date, then Pioneer's obligation to pay accrued and continued despite the fact that Marine itself became affected by an Event of Default at a later date. To find otherwise would allow a paying party to take advantage of its failure to pay, in circumstances where any subsequent Event of Default might well be caused in part by that failure to make payment. This at least clarified the scope of the application of section 2(a)(iii), i.e. it has no retrospective effect on amounts which accrue prior to the Event of Default.

Payment under protest - implications for the law of mistake

Marine sought to recover from Pioneer the sum of US\$ 5 million, which it paid under protest in February 2009.

The court found that there was no general principle of restitution under English law entitling a person to recover money on the ground that it was not due. Accordingly, to recover the US\$ 5 million, Marine had to fall within one of the established categories recognised by English law as sufficient to make retention of the money by the other party unjust, i.e. unjust enrichment. In this case, mistake was the only such ground relied upon.

Marine argued that its mistake was that there was a real and substantial chance that Pioneer was not affected by an Event of Default in January 2009 and that payment of the US\$ 5 million was therefore due. This raised the question of the degree of doubt sufficient for a mistake claim.

The court held that there might be cases where a payer could said to be mistaken, even if he had doubts, provided that he paid concluding that it was more likely than not that he was liable to pay. However, on the facts, Marine made the payment thinking that it was more likely than not that it was not liable to pay and that could not properly be described as a mistake. The real reason Marine made the payment was not because it was mistaken, but because it wanted to avoid the risk of Pioneer designating early termination.

As a result, the case confirms that a party may claim for return of monies paid on the basis of mistake if the party believed at the time of making the payment that it was more likely than not that the payment was due. Caution should be exercised when making payments where there is a doubt as to whether the payment is due because the level of doubt may not be sufficient to allow recovery of the sums paid in those circumstances.

The doctrine relating to penalties: Commercial Court upholds Early Termination provisions in 2002 ISDA Master Agreement – *BNP Paribas v Wockhardt EU Operations (Swiss) AG* [2009] EWHC 3116 (Comm)

In December 2009, the Commercial Court was asked to decide whether the Early Termination provisions in the 2002 ISDA Master Agreement were penal in nature and, therefore, unenforceable. The ISDA Master Agreement is, and has for many years been, very widely used in all types of derivative transactions and a decision to this effect would have had wide-ranging effects in the financial markets.

BNP and Wockhardt were parties to a 2002 ISDA Master Agreement with accompanying schedule, pursuant to which certain foreign exchange transactions were entered into. Wockhardt failed to make a number of payments due to BNP under these transactions. Consequently, BNP elected to terminate all outstanding transactions. BNP subsequently submitted a written statement of calculations pursuant to section 6(d)(i) of the ISDA Master Agreement showing the Early Termination Amount payable by Wockhardt. The Early Termination Amount claimed by BNP was, apart from interest, made up of:

- unpaid amounts already due under specific deals; and
- a "Close-Out Amount" calculated in accordance with the 2002 ISDA Master Agreement.

No payment was made by Wockhardt and BNP commenced proceedings against Wockhardt for the Early Termination Amount. Wockhardt contended that, inter alia, the Early

Termination and related payment provisions relied upon by BNP were unenforceable by reason of the doctrine relating to penalties. BNP applied for summary judgment.

The judge referred to Lord Dunedin's well-known statement in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 that a penalty clause was a clause which stipulated a defined sum payable on one or more breaches of contract "if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably have proved to have followed from the breach".

The fact that the clause in the 2002 ISDA Master Agreement specified the method by which such a sum (the Early Termination Amount) was to be determined rather than pre-defining the sum payable would not save it from being a penalty if the application of the method necessarily resulted in an amount that was extravagant and unconscionable. In order to determine whether the clause was penal it was therefore necessary to consider what was due to BNP following termination for breach:

- As far as the unpaid amounts were concerned, they had already fallen due prior to the termination and there was nothing penal in requiring Wockhardt, the defaulting party, to pay those.
- The calculation of the Close-Out Amount was based on the cost that would be incurred in replacing the transactions that had been terminated or providing the economic equivalent of those transactions. It seemed that this was designed to put BNP into the same position it would have been in had the contract not been validly terminated on account of Wockhardt's breach, i.e. to compensate it for its loss of bargain.

However, whether BNP was entitled to damages for loss of bargain, i.e. whether the Close-Out Amount was extravagant or unconscionable, depended on whether Wockhardt's non-payment of the amounts due amounted to a breach of condition, which entitling BNP to terminate the contract.

This derives from the established principle that if a party breaches a term of a contract which is classified as a condition, the other party is entitled to terminate the contract and claim damages for any losses suffered as a result, including loss of bargain. If, however, the term that has been breached is only a minor term of the contract (a warranty or an innominate term functioning as such), the right to terminate does not arise and any damages are limited to compensation for losses suffered as a result of that particular breach (for example, interest for late payment).

The judge held that even though the 2002 ISDA Master Agreement did not contain the words "condition" and "repudiatory breach", the parties had agreed that a breach of the payment obligation would entitle the non-defaulting party to designate an Early Termination Date, in which case no further payments or deliveries would be due and the non-defaulting party would, effectively, be compensated for loss of its bargain. In effect, the parties had spelled out the consequences which resulted from a

breach of condition and, as such, had to be taken to have agreed that the payment obligations under the ISDA Master Agreement should have that status.

The judge further considered the principle, also stated by Lord Dunedin in *Dunlop*, that there was a presumption that a clause was a penalty when "a single lump sum is made payable by way of compensation on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage".

In particular, Wockhardt submitted that, in the present case, there were two indicators of the penal nature of the provision that required the sort of factual considerations which made the matter unsuitable for summary judgment. The first indicator was that the same sanction (i.e. termination of the ISDA Master Agreement and payment of the Early Termination Amount) was to be applied to breaches of very different seriousness (regardless of whether the default was a small default on one transaction, a large default on one transaction, or a large default on many or all transactions). The second was that the clause provided for the payment of a fluctuating amount, as the Early Termination Amount to be paid would alter according to market rates or volatility, matters which were extraneous to the breach.

The judge did not accept these submissions. While he conceded that the fact that the clause was capable of application to several breaches of different seriousness might well be an indicator that it was penal in nature, that was irrelevant in this instance as he had already found that the payment obligation was a condition of the agreement. The fact that the amount to be paid would fluctuate according to the movements of the markets was not extraneous to breach but instead a circumstance that had to be taken into account in determining the present value of the contract at any given time.

While the judgment was not surprising in its outcome, it is significant to note that whether a particular contract term amounts to a condition or a warranty can be a decisive factor if a court is asked to determine whether a liquidated damages provision is enforceable as a genuine pre-estimate of loss or void as a penalty.

Lord Justice Jackson publishes final report in his review of civil litigation costs

On 14 January 2010, Court of Appeal judge, Lord Justice Jackson, published the final report in his review of civil litigation costs.² The 557-page report, which is probably the most significant development in civil litigation since the introduction of the Civil Procedure Rules under the auspices of Lord Woolf in 1999, contains recommendations designed to bring under closer control the costs associated with bringing a civil claim in the English courts.

The review was instigated in November 2008 by the then Master of the Rolls, Sir Anthony Clarke, in response to concern amongst the judiciary at the increasing costs of litigation. He appointed Lord Justice Jackson, who was aided by a group of "assessors" drawn from the judiciary and the legal profession, to *"carry out an independent review of the rules and principles governing the costs of civil litigation and to make recommendations in order to promote access to justice at proportionate cost"*. During a year-long investigation and consultation process, Lord Justice Jackson looked at issues including cost-shifting, proportionality, fixed costs and contingency fees and undertook comparisons of the costs regime in England and Wales with those in other jurisdictions, such as Australia and Canada.

As part of the consultation process, Lord Justice Jackson visited Olswang on two occasions to learn how we approach the issue of costs budgeting (i.e. estimating the costs which are likely to be incurred on a piece of litigation). Using our software, Lord Justice Jackson undertook a costs-budgeting exercise based on the facts of a real case, an exercise which he described as *"an invaluable learning experience"*. This led him to recommend in his final report the development of training in costs budgeting for all solicitors, barristers and judges.

Other major recommendations in the report include:

- abolishing the indemnity principle, i.e. the principle that a successful party cannot recover from an unsuccessful party more by way of costs than the successful party is liable to pay its lawyer;
- reforming the law relating to conditional fee agreements ("CFAs") - described by Lord Justice Jackson as *"the major contributor to disproportionate costs in civil litigation in England and Wales"* - to end the successful party's ability to recover from his opponent any success fee and after-the-event ("ATE") insurance premium. If this recommendation is accepted, it will still be possible for a client to enter into a CFA with its lawyer, but the client will bear the cost of any success fee or insurance premium, rather than recovering it from its opponent;
- "qualified" one-way costs shifting in types of litigation where a claimant with a meritorious case should not be deterred from bringing its claim by the risk of adverse costs. Examples of such types of litigation include personal injury, clinical negligence, judicial review and defamation claims. Under this proposal, a claimant would not be required to pay the defendant's costs if the claim was unsuccessful, but the defendant would be required to pay the claimant's costs if it was successful, subject to two qualifications: firstly, that unreasonable or otherwise unjustified behaviour by a party might result in the court making a different costs order; and secondly, the parties' financial resources might justify there being two-way costs shifting. In no longer requiring an unsuccessful claimant to pay the defendant's costs (provided his conduct is reasonable), this proposal would mean the end of the long-standing "loser pays" principle;
- a dual system of costs in fast track cases³ (other than personal injury claims) under which, depending on the nature of the claim, costs are either fixed or there is a financial limit on the costs recoverable (a limit of £12,000 is proposed for pre-trial costs) and establishing a Costs Council to review those fixed costs;
- permitting lawyers to enter into contingency fee agreements with their clients in relation to "contentious" business (at present, these are only permitted for non-contentious business). This proposal is subject to two conditions: firstly, if the unsuccessful party to the proceedings is ordered to pay the successful party's costs, the unsuccessful party will only be required to pay a "conventional amount" for costs, with the successful party bearing any difference; and secondly, in order to protect clients' interests, that the terms on which lawyers and clients can enter into contingency fee agreements are regulated;
- reforming the Patents County Court to ensure that lower value intellectual property disputes are conducted in a cost-effective environment, including allowing a party to recover costs from its opponent according to cost scales and capping total recoverable costs at £50,000 in contested actions for patent infringement and at £25,000 in all other cases;
- introducing a scale of benchmark costs for routine bankruptcy and insolvency cases;
- in defamation and breach of privacy claims, increasing the general level of damages awarded by 10% and introducing qualified one-way costs shifting, as described above. This is intended to compensate to some degree for the proposal that success fees and after-the-event insurance premiums would no longer be recoverable from unsuccessful parties, so that it does not reduce access to justice for less well-off claimants;
- retaining the current pre-action protocols for specific types of litigation, but repealing the sections of the Practice Direction - Pre-Action Conduct which were intended to act as a general protocol in other types of cases, as its "one size fits all" approach often results in parties incurring unnecessary and wasteful pre-action costs. It would still be open to the court to penalise any unreasonable pre-action behaviour by imposing costs sanctions;
- instigating a "serious campaign" to promote the understanding and use of alternative dispute resolution ("ADR") amongst the judiciary and lawyers, although ADR should not be made mandatory in all cases;
- a "menu" of different options for the extent of disclosure required in large commercial cases, as the costs of standard disclosure are likely to be disproportionate in such cases;
- using case management measures and costs sanctions to control the length and content of witness statements and expert reports;

- introducing a number of measures to enable judges to take a more robust approach to case management, which Lord Justice Jackson stated "*can and should be an effective tool for costs control*", including:

- allocating cases to judges with the relevant expertise (a process known as "docketing") and ensuring, as far as possible, that a case stays with the same judge throughout the litigation process;
- producing standardised case management directions; and
- using case management conferences and other interim hearings as effective occasions for case management and ensuring that they do not generate unnecessary costs (for example, where directions could have been given without a hearing);

- reversing, either judicially or by a rule change, the effect of the widely criticised decision in *Carver v BAA plc* [2008] EWCA Civ 412 on the meaning of "judgment more advantageous" in Part 36 of the Civil Procedure Rules, to make it clear that, in any purely monetary case, the expression "more advantageous" means better in financial terms by any amount, however small; and

- where a defendant rejects a claimant's Part 36 offer but fails to beat it at trial, enhancing the claimant's recovery by 10% (although there may be a case for scaling down this uplift in higher value claims - for example, those over £500,000).

Two areas where Lord Justice Jackson felt costs were under control and proceedings conducted in a proportionate manner were large commercial claims heard in the Commercial Court and Technology and Construction Court, and his report contains "only modest recommendations" in respect of such proceedings.

Where next for Lord Justice Jackson's recommendations? Although the Justice Secretary, Jack Straw, has confirmed that the Ministry of Justice will consider them in depth and "*set out the way forward in due course*", there is no guarantee that any of the recommendations in the final report will be implemented, particularly those which will require primary legislation, such as the introduction of contingency fees. As the report was commissioned by the Master of the Rolls in his position as a senior member of the judiciary, rather than by the Ministry of Justice, the Government - whichever political party is in power following the election - is not bound to accept anything in the report. Time will tell.

² Lord Justice Jackson's final report is available at http://www.judiciary.gov.uk/about_judiciary/cost-review/index.htm

³ Fast track cases are those with a value of more than £5,000 but not more than £25,000 (£15,000 where proceedings were issued before 6 April 2009) where the trial is likely to last for no longer than one day.

Rome I Regulation – the law applicable to contractual obligations

New rules now apply to determine the governing law of contracts concluded on or after 17 December 2009. The Rome I Regulation (Regulation (EC) No. 593/2008 on the Law Applicable to Contractual Obligations) ("Rome I") will be applied by the courts of all EU Member States with the exception of Denmark.

The rules for determining which law the English courts should apply when resolving a contractual dispute were previously set out in the Rome Convention on the Law Applicable to Contractual Obligations 1980 (the "Rome Convention"). Those rules continue to apply to contracts entered into before 17 December 2009. Rome I has converted the Rome Convention into a regulation but has not radically altered the position, although there are a number of changes which are material when advising on questions of applicable law.

As with the Rome Convention, Rome I applies to contractual obligations in civil and commercial matters, although there are a number of specific exclusions from the scope of Rome I. The most notable exclusion is for the obligations arising out of dealings prior to the conclusion of a contract (Article 1(2)(i) of Rome I), which are treated as non-contractual obligations and dealt with under Article 12 of the Rome II Regulation (Regulation (EC) No. 864/2007 on the Law Applicable to Non-Contractual Obligations). Arbitration and jurisdiction agreements are also outside the scope of Rome I. The first question for a practitioner is therefore whether the Rome Convention, Rome I or in fact neither should be used to determine the applicable law.

Express choice of law

Rome I has clarified that a choice of law may be made other than in express terms - it can be "*made expressly or clearly demonstrated by the terms of the contract or the circumstances of the case*".

Many contracts in international commerce provide for the exclusive jurisdiction of the courts of England and Wales, and it is usually preferable for the applicable law to mirror the jurisdiction. It is therefore helpful that recital 12 to Rome I notes that one of the factors to be taken into account in determining whether a choice of law has been demonstrated is an agreement that a Member State is to have exclusive jurisdiction. While this does not appear in the body of the Regulation, it is therefore confirmed to be a factor which may demonstrate a choice of governing law.

There is a notable substantive amendment to the rules on displacement of an express choice of law. Any choice of law is without prejudice to the overriding provisions of Community law if all other elements of the situation are located in one or more Member States.

Applicable law in the absence of choice

Article 4(1) of Rome 1 sets out rules for determining the governing law of particular types of contract. For instance, under Article 4(1) (a), contracts for the sale of goods are governed by the law of the country where the seller has his habitual residence. Further contract types are listed in Article 4(1)(b) to (h).

Should the specific governing law rules not cover the type of contract in question, the general rule is then applied (as it was under the Rome Convention): the contract will be governed by the law of the country where the party required to effect the characteristic performance of the contract has his habitual residence (Article 4(2)). An "escape clause" has been written in so that where the contract is "*manifestly more closely connected*" with a country other than that indicated by the application of the rules, the general rules will not apply (Article 4(3)). This should be of particular use for interrelated contracts, where it is of commercial importance for a single law to be applied to the whole transaction rather than having different laws applying to each of the component parts of the transaction.

If the applicable law cannot be determined using the rules in Articles 4(1) and 4(2), there is a final default position provided by Article 4(4), namely, that the contract will be governed by the law of the country with which it is "*most closely connected*".

In line with the model of the Rome Convention (but with some differences to the text of the Rome Convention), Rome I also goes on to set out specific provisions for consumer (Article 6), insurance (Article 7) and employment contracts (Article 8).

Overriding provisions

As summarised above, the parties' freedom to choose the law applicable to the contract between them is paramount in Rome I as it was in the Rome Convention. However, there are still exceptions. Whether the applicable law is determined by express choice or by using the rules laid down by Rome I, the law determined under the rules described above will not affect the overriding mandatory provisions of the law of the place in which the dispute is being heard (Article 9(2)). We are now offered better guidance on when this will be the case because Rome I defines "*overriding mandatory provisions*" (Article 9(1)) as "*provisions the respect for which is regarded as crucial by a country for safeguarding its public interests ... to such an extent that they are applicable to any situation falling within their scope*". Further, effect may be given to the mandatory overriding provisions of the country where the obligations must be performed to the extent that those provisions render performance of the contract unlawful (Article 9(3) of Rome I).

For further information please contact:

Editor



Jeremy Mash

Partner
+44 (0) 20 7067 3270
jeremy.mash@olswang.com

Contributors

Harry Hatzipavlidis
Kate Taylor
Miriam Schmelzer
Sarah Speller
Tamsin Blow